CalPERS

Office of Governmental Affairs
P.O. Box 942720
Sacramento, CA 94229-2720
Telecommunications Device for the Deaf - (916) 795-3240
(916) 795-3689, FAX (916) 795-3270

February 15, 2005

AGENDA ITEM 3

TO: MEMBERS OF THE BENEFITS AND PROGRAM ADMINISTRATION COMMITTEE

I. SUBJECT: Assembly Constitutional Amendment 5 (Richman)—Defined Contribution Plan

Assembly Constitutional Amendment 1, 1st Extraordinary Session (Richman)—Defined Contribution Plan

II. PROGRAM: Legislation

III. RECOMMENDATION: Oppose

ACA 5 and ACA 1x would create a fundamental shift in the retirement security of future public employees. The value of professionally managed investments, pooling of participant investment and mortality risk, inflation protection, and catastrophic death and disability benefits would be forfeited under a DC plan.

IV. ANALYSIS:

ACA 5 and ACA 1x would amend the California State Constitution to prohibit any newly hired public employee, including state employees, from enrollment in a defined benefit public pension plan beginning July 1, 2007. Both bills provide for the establishment of the California Public Employee Defined Contribution Plan to provide a defined contribution retirement benefit to future public employees.

If either bill is passed by the Legislature, it would require voter approval during the next statewide election.

Background

Defined Benefit Plans
Defined benefit (DB) plans provide participants a predictable lifetime benefit based upon a participant's years of service under the plan, retirement formula factor, and

age. The majority of public sector DB plans are funded through employee and employer contributions which, by plan design, may fluctuate on an annual basis. Public sector DB plans usually provide retirees some type of annual cost-of-living increase to offset loss of purchasing power due to inflation. Investments are managed by professional investment staff. If investment returns fall below the assumed rate of return, employers are liable for the additional assets necessary to fund the defined benefit. Likewise, if investment returns are above the assumed rate of return, the excess assets reduce employer costs.

Defined Contribution Plans

Defined contribution (DC) plans include 401(k), 403(b), or public sector 457 plans. A participant's benefit from a DC plan is based upon the contributions by the participant, any employer contributions, and investment gains or losses. The employer or the participant may be responsible for the plan's administrative expenses, but investment management fees are typically paid by the participant.

Benefits can be paid from a DC plan in several ways; the most common are monthly payments until account assets are depleted, a lump-sum payment of account assets, or the purchase of a private annuity that pays a monthly benefit for a fixed period. DC plans are usually "qualified plans", allowing the participant to defer taxes on the contributions made to the plan (up to a maximum amount), thereby lowering their annual taxable income. In addition to participant contributions, most DC plans permit employer contributions, which participants "own" after a specified vesting period.

CalPERS Defined Benefit Plan

CalPERS provides a DB plan for employees of the State of California, schools, and contracting local agencies. CalPERS is the largest public pension fund in the United States, with a market value of over $182 billion as of December 31, 2004. The CalPERS Board applies strict guidelines for investing these assets, including standards for safety, diversification, and liquidity.

The CalPERS DB plan provides a lifetime benefit based upon a member's years of service, age, retirement benefit formula, and final compensation. Participation in the DB plan is mandatory for most state employees, classified school employees, and employees of a contracting local agency. Benefits are funded by member contributions, employer contributions, and investment returns generated by CalPERS. As of June 30, 2004, the average monthly benefit paid is $1,669 per month.

Employers can select from a variety of formulas and contract options for all employees or groups of employees. Most local agency employers adopting a new benefit package or an enhancement to an existing package do so after completing contract negotiations with an employee group. Local agency employers are required to have CalPERS retirement benefit changes adopted by a majority vote of the governing body after the proposal has been publicly heard before the body on at least two occasions, no less than twenty days apart.

All retirement plans provided by CalPERS include a basic death and disability benefit for members, thereby eliminating the need for an employer to contract with an independent provider of such benefits.

CalPERS maintains separate accounts for members and employers. Member contributions are fixed by statute and forwarded to CalPERS for deposit into individual accounts. Upon separation from employment, a member may choose to withdraw his/her member contributions plus interest or to leave the funds in the system. If the funds are withdrawn, no employer contributions are paid to the member.

In addition to the CalPERS DB plan, the state offers a DC plan (401(k) or 457) for its employees on a voluntary basis. CalPERS also administers a DC 457 plan available to contracting local agencies.

<u>Annual Valuations: Employer Contribution Rates</u>
Employer contribution rates are determined by CalPERS during an annual valuation of the assets and liabilities of each employer's retirement plan(s). When establishing employer contribution rates, the actuarial calculations take into account a variety of actuarial assumptions including the values of the assets held in trust by CalPERS and two main factors:

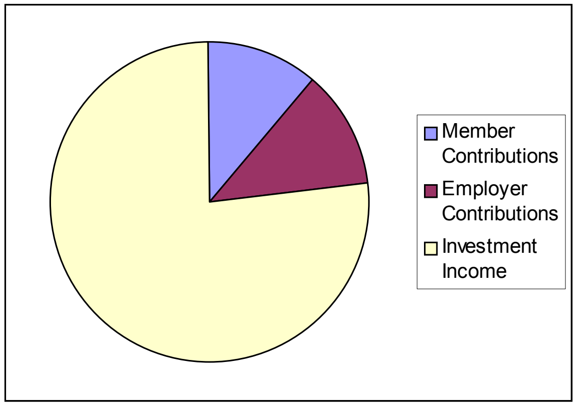
1. The employer's normal cost for benefits. This is the constant cost an employer would need to pay if all actuarial assumptions are met. This factor is used to ensure that any benefits employees have already accrued will be funded if they chose to retire.

2. The employer's amortized unfunded liabilities or surpluses for its population that result from changes in benefit levels, population characteristics, and asset gains or losses.

Employer contribution rates can fluctuate on an annual basis due to a variety of factors, and rates always reflect the value of assets from approximately one year prior for the state and two years prior for public agencies. For example, the current contribution rate required of public agency employers for fiscal year 2005/2006 is based upon the value of assets and employee demographics as of June 30, 2003. For many employers this rate cycle has meant that the cost of benefit increases granted to employees between 2000 and 2002 have been considered in their contribution rate along with a corresponding decrease in the value of plan assets. The decrease in plan assets is responsible for nearly 80% of employer contribution rate increases between 2002 and 2004.

The following chart indicates that over the past 10 years (ending June 30, 2004), member contributions accounted for 11.5% and employer contributions represented 11.7% of the income to the plan, with investment income providing approximately 76.8% of income to the plan. During this time period member contributions equaled employer contributions because members always make contributions, regardless of funded status. Employer contributions vary depending on investment earnings, with employers receiving the benefit of positive investment earnings.

CalPERS' income sources:



CalPERS has implemented risk pooling as a way to assist in leveling public agency employer contribution rates. Risk pooling is the process of combining assets and liabilities across employers to produce large risk sharing pools. These risk sharing pools can help dramatically reduce or eliminate the large fluctuations in the employer contribution rates caused by unexpected demographic events. In mid-2004, risk pooling became mandatory for employer plans of less than 100 employees, and optional for all others.

<u>Proposed Changes</u>

<u>ACA 5</u>
Beginning July 1, 2007, ACA 5 would prohibit employees of governmental entities within California from enrolling in a DB plan that provides a benefit based on age, service credit, and final compensation. Specifically, ACA 5:

- Establishes the California Public Employee Defined Contribution Plan. No details are provided regarding the purpose or governance of this plan.
- Defines "public agency" as any public entity or political subdivision organized in the state, or any department, instrumentality of government, or agency thereof.
- Permits a public agency, including the State of California, to contract with a third-party administrator to manage the employer's DC plan.
- Allows any active member to transfer the "set present value" of the "member's interest" in the CalPERS DB plan to the DC plan; however, "set present value" and "member's interest" is not defined. This member transfer could occur only between July 1, 2007 and December 31, 2007.
- Prohibits employer contributions to a DC plan beyond a fixed percentage of payroll, but that percentage is not yet included in the bill. For local

jurisdictions, these employer contribution limits could be increased by a 2/3 vote of local voters.

ACA 1x

ACA 1x is nearly identical to ACA 5. ACA 1x, however, does not propose to limit employer contributions to the DC plan. ACA 1x also specifically prohibits any other measure on the same statewide ballot relating to public retirement plans from being enacted if ACA 1x receives a greater number of votes.

Legislative History

2004 Chapter 214 (SB 1105, Comm. on Budget & Fiscal Review)—Established the Alternative Retirement Plan for new state employees whereby employees contribute to a DC plan administered by the Department of Personnel Administration/Savings Plus Program for their first 24 months of service. After the first 24 months, the employee becomes a member of the CalPERS DB plan. *CalPERS' position: None*

1996 AB 3252 (Kaloogian)—Would have created the Public Employees' Defined Contribution Retirement Plan. Active state employees and contracting public agency employees would have had the opportunity to transfer their CalPERS DB assets to a DC plan, and participate only in that DC plan. *CalPERS' position: Oppose*

1990 Chapter 1659 (SB 2026, Craven) – Established the CalPERS 457 Deferred Compensation plan for employees of contracting public agencies. Public agencies may contract with CalPERS to provide this voluntary program to their employees. All program costs are paid by those agencies and participants. *CalPERS' position: Sponsor*

Issues

1. Arguments by Those in Support

Proponents argue that the cost of existing DB benefits is too high, with guaranteed benefit levels exceeding those provided to private sector employees and those provided by public pension plans in other states.

Proponents also argue that employers need stable employer contribution rates in order to budget effectively. The author states that retirement related payments from the state's General Fund (for all types of plans, including CalPERS, CalSTRS, etc.) are forecasted to rise from $1,901 million in 2004/2005, to $3,424 million in 2009/2010[1]. Local agencies have also seen employer contribution rate increases in the last fiscal year. Current CalPERS DB plan participants do not share the cost of benefit enhancements. The

[1] Assemblyman Keith Richman's Press Release of December 6, 2004

majority of CalPERS member contribution levels are fixed as a percentage of salary, regardless of investment returns. Employer contributions fluctuate on an annual basis, based in part on investment returns.
In a press release issued on December 6, 2004, the author argues that DC plans will provide employees with greater flexibility, stating that DC plans are more portable and allow employees to take control of their retirement decisions. The author also believes a DC plan helps meet the needs of a dynamic workforce by providing flexibility and portability not provided by a DB plan.

In addition, the Howard Jarvis Taxpayers Association indicated to reporters that CalPERS corporate governance activities were a factor in the organization's interest in this issue.[2]

In his State-of-the-State address, Governor Schwarzenegger endorsed the concept of a DC plan to replace the current DB plans.

Organizations in Support: Cal-Tax; Howard Jarvis Taxpayers Association; Americans for Tax Reform (This list contains registered support and those stating support in the media.)

2. <u>Arguments by those in Opposition</u>

Opponents argue that CalPERS DB plan benefits are reasonable; the average monthly benefit paid is $1,669, and the national average is $1,500. The small difference in benefits can be primarily attributed to California's significantly higher cost of living. In addition, where the state has difficulty in attracting and retaining highly skilled mid-level employees, DB plan benefits help offset lower public sector pay by providing a lifetime benefit for members and their beneficiaries at a predictable amount that cannot be outlived.

Opponents state that DB plans provide taxpayers an insurance policy against expensive public assistance demands from DC plan participants that outlive their benefits. Because DB plans provide a benefit for life with inflation protection, and provide death and disability benefits, the probability of a DB plan retiree requiring public assistance is less than those participating in a DC plan.

Opponents also argue that the majority of employer contribution rate increases have come as a result of decreased investment returns during economic downturns, not increases in member benefits. In many cases employees share the cost of benefit improvements granted by the employer. During periods of high investment returns, however, most employees continued to pay member contributions, while many employers enjoyed contribution holidays.

---

[2] "Politics: Schwarzenegger taking aim at California public DB plans", *Pensions & Investments*; January 10, 2005.

Organizations in Opposition: California State Teachers' Retirement System; California School Employees Association; California Correctional Supervisors Organization; California Organization of Police and Sheriffs; California State Employees Association; California Professional Firefighters; California Labor Federation; California Teachers Association; Service Employees International Union; California Association of Highway Patrolmen (This list contains registered opposition and those stating opposition in the media.)

3. <u>Additional Information Regarding Author's Intent</u>

ACA 5 and ACA 1x contain very little detail. The author has indicated that he intends to introduce legislation to provide the detailed statutory provisions necessary to implement these proposed constitutional amendments.

While such legislation may be introduced either before or after voter approval, on December 6, 2004, Assembly Member Richman issued a press release with additional details about his proposal. The author states that his intent is to provide an enhanced employer contribution with matching employee funds for police officers and firefighters to recognize their shorter career spans. The author's staff has also indicated to the press that the maximum employer contribution would be 6% for miscellaneous employees and 9% for safety employees, subject to matching contributions from the employee.[3]

The press release indicates the intent to use private fund administrators, presumably to operate the Public Employees Defined Contribution Plan. In addition, the author states the desire to "encourage" employee enrollment, implying that employee participation would not be mandatory. The press release also states that the vesting period for employer defined contribution plans would be less than 5 years.

4. <u>DC plans do not provide death or disability benefits.</u>

CalPERS DB plan provides death benefits, survivor benefits, and disability benefits, which are not available under a DC plan. These benefits are incorporated in the normal cost of the CalPERS DB plan. In addition, public employees are not typically eligible for the same state disability benefits provided to private sector employees.[4] Public employees excluded from Social Security also have less disability and survivor protection than available to employees covered by Social Security.

---

[3] "Pension proposal gets support; Constitutional amendment to overhaul system introduced", *San Francisco Chronicle*; January 7, 2005

[4] The state basic Non-industrial Disability Insurance (NDI) program provides up to $135 per week, up to 26 weeks per year. The enhanced NDI program provides up to 50% of pay for up to 26 weeks. The State Disability Insurance (SDI) provides up to $840 tax-free per week for up to 52 weeks per year.

5. Adequacy of DB and DC retirement benefits.

Proponents argue that when participants of DC plans save significant amounts early in their careers, utilizing investment vehicles that are appropriately and regularly balanced, it is possible to equal or exceed the benefit they would receive from a DB plan. The benefit provided by a DC plan, however, depends on an individual's investment choices, the length of time the individual contributes to the DC plan, and the condition of the financial markets at the time of retirement.

On the other hand, the CalPERS DB plan provides a guaranteed lifetime retirement benefit based on age at retirement, years of service, and salary. In a DB plan, the risk associated with investing assets is pooled across the entire plan, rather than each investor bearing personal risk. If the market is down at the time of retirement, DB plan participants are protected by a guaranteed benefit, while a DC plan participant's benefit is adversely affected.

In addition, CalPERS DB plan assets are managed by professional investment staff with a long track record of producing earnings far exceeding most DC plan participants. The DB plan also provides access to asset classes that are unavailable to individual investors, resulting in greater diversification. Employees who manage their own retirement assets are generally too conservative in their asset allocation choice, investing in stable value and other fixed income assets rather than equity assets with greater returns. According to the Employee Benefit Research Institute, more than 38% of workers in their 20s and 27% of workers in their 30s hold no stock funds in their accounts.

6. CalPERS provides better investment returns than DC plans, with lower administrative costs.

A 2004 study by an independent firm that measures pension performance, Cost Effectiveness Measurement, Inc. (CEM), found that CalPERS added more value to its investment portfolio at less risk and at a lower cost than other large public pension funds. CEM also found that CalPERS management of the fund added an average additional return of $1.4 billion.

According to the *San Francisco Chronicle*, the median DC plan return from 1990 through 2002 was 6.86 percent.[5] For the same time period, CalPERS rate of return was 8.9 percent.

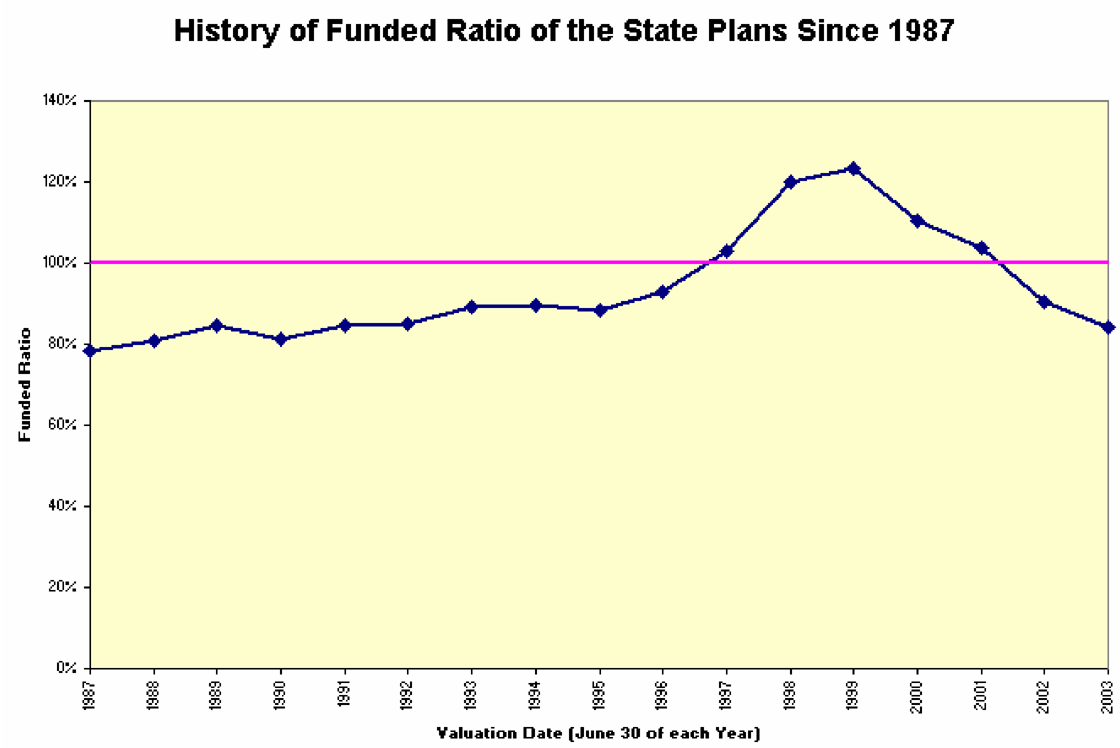
The cost of administering the CalPERS DB plan is 0.12% of assets (12 basis points), which includes counseling and educating members, individual employer services and plan valuations, and administering complex

[5] "Public Pensions in Flux", *San Francisco Chronicle*; January 9, 2005.

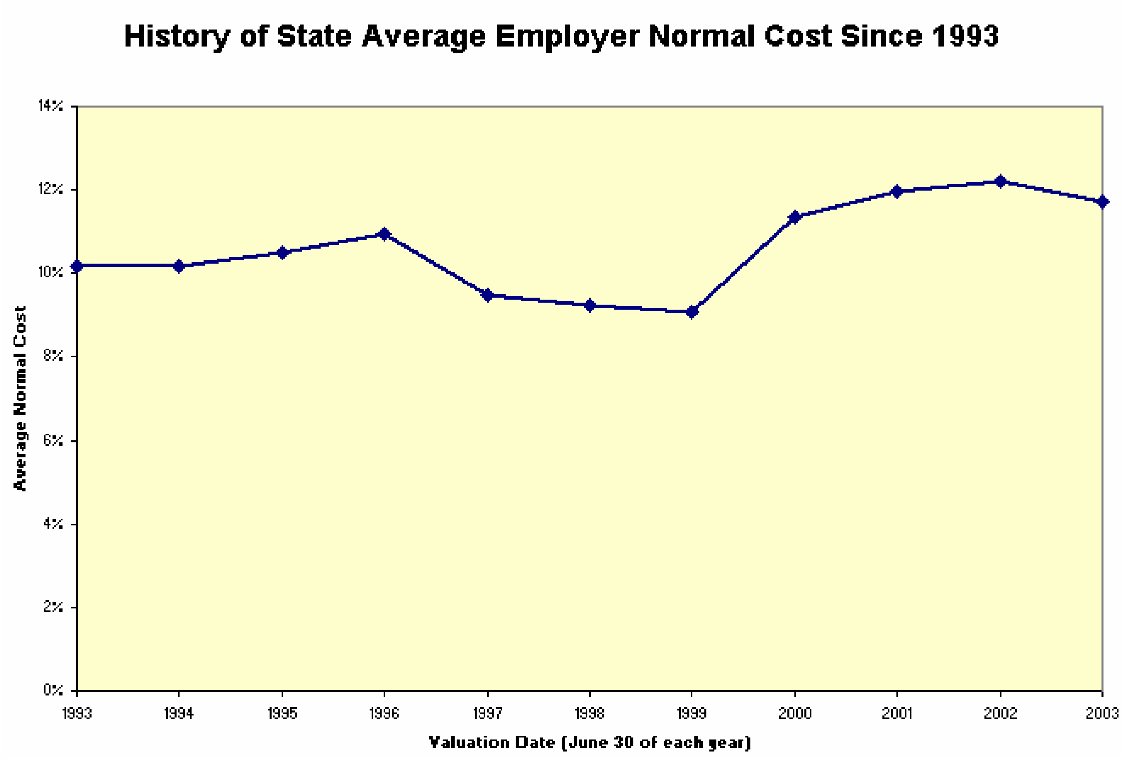
retirement, disability, and survivor benefits with a significant variety of options for both employers and members. The investment costs associated with the CalPERS DB plan are an additional .25% of assets (25 basis points). According to Morningstar, the average expense ratio of a domestic equity fund is 1.49% (149 basis points), and 1.13% (113 basis points) for a taxable bond fund. This cost does not include the overhead associated with offering a 401(k), including recordkeeping of individual accounts, contracting with fund providers, and providing education to participants. The total annual costs of a DC plan can rise to as much as 2% (200 basis points).

7. Financial condition of public DB plans.

The funding status of DB plans has diminished with the major downturns in the investment markets. Because of an asset smoothing process, this negative funding status may continue for a few years in spite of recent increases in investment earnings. As indicated in the graph below, the funded status of the state plans is approximately 84%, declining from a high of 123.5%.



CalPERS is one of the best-funded state systems according to a 2003 study of state systems by Wilshire Associates Inc. The funding status of the CalPERS DB plan is healthy and has remained relatively stable. The chart below shows the relatively steady normal cost of the program. The normal cost, expressed as a percentage of pay, represents the cost associated with an average member's increased benefit over the member's career. This steadiness reflects that the increase in liabilities associated with benefit enhancements have been offset by other beneficial changes in economic and demographic conditions, particularly the decreased rate of inflation.



8. Portability of DC plans.

In his press release, the author argues that tax-qualified DC plans offer public employees greater flexibility, and portability features provide a potential for more retirement income for employees who have several changes during their career.

However, according to a study conducted by the human resources consulting firm Hewitt Associates, 57% of employee who leave their companies choose cash payouts—including the monies contributed by the employer for the purpose of retirement—rather than rolling the funds over to the next employer's retirement plan.

As a result of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) in 2001, member contributions of a DB plan offer similar portability as DC plans. Upon separation from employment, member contributions may be "rolled-over" to a private 401(k) or Individual Retirement Account (IRA), thereby sheltering the funds from tax penalties. In addition, EGTRRA permitted DB plans to accept funds from a variety of common DC accounts for the purchase of service credit.

Over 1,400 public agency employers participate in the CalPERS program, which provides a great deal of additional portability for career public servants even when changing employers. Under both a DB and a DC plan, the employee may forfeit employer contributions if employment is terminated prior to vesting. Within the CalPERS program, however, employer contributions are not forfeited if the employee transfers to another CalPERS-covered employer or to another public retirement system that has established a reciprocal agreement with CalPERS.

The primary difference is the portability of employer contributions. Under the CalPERS DB plan, employees are not eligible to withdraw or transfer employer contributions. The existing DB plan could be changed to provide greater portability of state employer contributions. The DC plan typically allows employees to transfer employer contributions upon separation of employment. Because the state's new Alternative Retirement Program does not require employer contributions during a new employee's first two years of employment, the proposed DC plan may increase state costs for short-term employees.

9. Participation in and experience of DC plans.

Participation in the CalPERS DB plan is mandatory. Unless participation in a DC plan is also mandatory, participation levels are likely to significantly decline. A study of large private DC plans by the National Bureau of Economic Research indicated that when employees were automatically enrolled at the time of hire, approximately 14% opted out when allowed to do so. Among those eligible to participate, 28% of employees opt not to participate in their employer's DC plan, according to the Federal Reserve Board's 1998 Survey of Consumer Finances.

10. Prevalence of DB plans in the private sector.

CalPERS and other significant pension systems have large memberships. The decline in the number of private sector DB plans has largely occurred among employers with fewer than 250 employees. A significant reason for this is federal regulation. Private sector DB plans are subject to the federal Employee Retirement and Income Security Act (ERISA), and compliance with these regulations can be costly and burdensome. Moreover, changes in federal law during the 1980s reduced or eliminated incentives for private sector employers to offer DB plans and increased the cost and liability associated with maintaining a DB plan.

Nevertheless, a 2002 Watson Wyatt survey found that 50 percent of Fortune 100 companies offered a DB plan as their primary retirement plan, while only 17 percent offered a DC plan as their primary retirement plan. The remaining 33 percent offered a cash balance plan, which is a hybrid plan that offers guaranteed benefits.

11. Experience in other states.

Employers have numerous options in the method in which to provide retirement benefits. Ninety percent of state and local government employees in the United States participate in a DB plan, according to the National Association of State Retirement Administrators (NASRA). DC plans may be offered as a voluntary retirement savings vehicle as a supplement to a DB plan. The state and many California public employers offer supplemental DC plans. DC plans may be offered as an alternative to, or in lieu of, a DB plan. DB and DC plans can also be combined into a hybrid system, which generally provides a minimum guaranteed benefit as well as a variable benefit.

DC or DB Plan Alternatives
Florida: In 2002, the Florida Retirement System established the Public Employee Optional Retirement Program as an optional alternative to its DB plan. The plan requires no employee contribution and provides a 9% employer contribution with default moderate risk investment options. When the DC plan was offered to existing employees in Florida's DB plan, less than 5% chose to transfer to the DC plan, with approximately 19% of new employees choosing the DC plan in the last fiscal year. Florida currently budgets approximately 1.7% of assets (170 basis points) for administering the program, and individual participants pay additional fees and expenses based upon their investment decisions.

DC Plan in Lieu of DB Plan
Michigan: In Michigan, all employees hired after March 1997 are only eligible for a DC plan. When given the option, only 7% of existing employees chose to transfer from the DB plan to the DC plan. The state contributes 4% of salary and matches voluntary employee contributions up to an additional 3%. Employees may make additional contributions up to the maximum allowable limit without an employer match. Indicative of the average American's aversion to investment risk, more than 40% of Michigan's DC plan assets are found in the plan's default money market fund, despite offering 23 different investment options. Current participants of the DC plan are charged for administrative services, plus additional fees and expenses charged for each investment option.

Nebraska: Public sector transitions to DC plans have had difficulties. The state of Nebraska recently converted back to a DB plan after 20 years under a DC plan. Studies of the state's DB and DC plan investment returns demonstrated that DC plan participants had an average annual return of 6% to 7%, while the professional money managers of the DB plan had average annual returns of 11%. Further compounding the state's problem, nearly 50% of all employees stayed in the DC plan's default fund even though they had 11 investment options and the state had made much effort to help individuals invest wisely. Nebraska retirement system officials were concerned that the state was wasting taxpayer money via matching contributions to workers' accounts.

DB/DC Hybrid Systems
Oregon: In 2003, Oregon established the Oregon Public Service Retirement Plan, a new hybrid system. Public employees hired on or after August 29, 2003 are required to enroll in the plan. A reduced DB benefit is funded by employer contributions, and the member contributes 6% of salary into the DC plan. The DC plan assets are invested by one entity, with earnings and losses credited to individual accounts; there is no individual self-direction of retirement assets. Employers may choose to "pick up" the member's 6% contribution requirement.

Ohio: Ohio provides a choice among a DB plan, a DC plan, and a combined plan to state employees hired after July 1, 2001. In each plan, the member contributes 10% of salary and the employer contributes 14%. The member contribution to the combined plan funds a reduced defined benefit, while the employer contribution (net of the unfunded actuarial obligation contribution) is credited to a DC plan. Approximately 0.7% of members have chosen the DC-only plan, and an additional 0.7% of members have chosen the hybrid plan.

12. Impact on CalPERS investments

Because ACA 5 or ACA 1x would allow current members to continue participation in the CalPERS DB plan, the current system would remain in operation throughout the lifetime of current members and their survivors. By closing the system to new members, these bills would result in reduced future contributions that CalPERS would otherwise receive. Over the long term, this is likely to affect the asset allocation of the fund; as members begin to receive retirement benefits in the future, the asset allocation will need to become more liquid. This liquidity is likely to have an adverse impact on fund performance in future years, increasing the cost of the DB plan.

Under self-directed DC accounts, investments such as real estate, housing, venture capital, and private equity cannot be accessed by individuals. Therefore, these asset classes and the jobs they create in California will be discontinued. CalPERS housing program, for example, was established during the recession of 1990-91 when funding for housing was limited. CalPERS has invested more than $19.5 billion in California, with $10.7 billion going to California-based companies, another $1.5 billion in financing for single family homes, and approximately $2 billion in urban redevelopment.

13. Impact on Employer Contributions

Amortization of the Unfunded Liability

The major impact on employer contributions to the CalPERS DB plan as a result of closing the plan to new entrants will come from potential changes in the amortization of the unfunded liability.

The California Constitution provides the CalPERS Board plenary authority over the actuarial methods and assumptions. The method of amortizing the unfunded liability, as well as the period of time over which the unfunded liability is amortized, are included in the Board's plenary authority.

Current Board policy stipulates the following:

- The amortization method is to amortize the unfunded liability as a level percentage of future payroll. This means each year's payment on the unfunded liability is larger than the previous year's payment by the same percentage as payroll is assumed to grow in the future.
- The amortization period varies according to the reason and date of origin of various components of the unfunded liability. Changes in liability due to benefit changes and changes in actuarial methods or assumptions are amortized over 20 years from the date of the change. Actuarial gains and losses are amortized by including 10% of the unamortized gains and losses in the employer's required contribution for the coming fiscal year.

Potential Changes in Current Board Policy

Amortization Method

If the plan is closed to new members, the CalPERS Board will need to assess whether changes to the current amortization policy should be made. In particular, the Governmental Accounting Standards Board (GASB) in Statement 27, *Accounting for Pensions by State and Local Governmental Employers*, requires that when a plan is closed to new entrants, the method of amortizing the unfunded liability must be either:

- As level dollar amount (i.e. the same dollar payment over each year of the amortization period), or
- As a level percentage of declining payroll of active members still covered by the plan. This means that payments start considerably higher than the payments under current Board policy (as applied to an open plan) and each year decrease by the same percentage as expected declining covered payroll.

It is highly likely that the Board, in order to produce employer contribution rates that comply with Generally Accepted Accounting Principals, would revise its policy on the method used to amortize the unfunded liability to one of the two prescribed by GASB Statement 27.

Amortization Period

In addition, the Board would have to consider whether the current amortization periods would remain appropriate in light of the closing of the plan. The Board's fiduciary duty would require them to assess the current and projected future financial strength of the plan, as well as the future ability of employers to make require contributions. The Board could very well shorten or lengthen the amortization periods according to the result of their assessment.

Potential Impact of Changes to the Amortization Policy

As explained above, if the plan is closed to new entrants, the CalPERS Board will review and potentially revise its amortization policy (both amortization method and amortization period). There is a wide range of possibilities regarding the impact on employer contributions; depending on changes to the amortization policy, there may be very little immediate impact on employer contributions or changes may substantially increase immediate employer contributions.

Amortization policies that produce little impact on immediate employer contributions also have the effect of substantially reducing any long-term savings to the employer. Conversely, changes in amortization policies that substantially increase immediate employer contributions will increase long-term savings to the employer. Short-term costs versus long-term savings are connected because the sooner the unfunded liability is eliminated by additional employer contributions, the greater the expected investment dollars that reduce the need for future employer contributions.

Estimated Fiscal Impact

The current Board amortization policy is to amortize the unfunded liability as a level percentage of payroll of active members. While there is a number ways that unfunded liability could be amortized, the amounts shown below are based upon the only interpretation available of CalPERS' current policy, namely that the amortization payments would have to start higher and decrease over time as the payroll of covered active employees declines. Further, the amounts shown below are based on no change in amortization period. Should either bill be enacted, the Board would have to determine whether the method and period used to produce the estimate below are appropriate.

Estimated Fiscal Impact of the Proposal (in $ billions)[6]
Amortization Method: Level Percent of Declining Payroll
Amortization Period: Same as Current Policy

	First Year (2007-08)	Ten Years (2007-08 to 2016-17)	Twenty Years (2007-08 to 2026-27)	Thirty Years (2007-08 to 2036-37)
State	(0.42)	(1.52)	8.14	19.00
Schools	(0.14)	(0.18)	2.88	5.64
Public Agencies	(0.26)	0.67	4.89	11.20
Total	**(0.82)**	**(1.03)**	**15.91**	**35.84**

Negative amounts represent increased cost to employers and positive amounts represent decreased cost to employers.

14. Permitting existing members to transfer to a DC plan

Between July 1, 2007 and December 31, 2007, ACA 5 and ACA 1x would allow existing CalPERS members to terminate membership and to enroll in a DC plan. ACA 5 provides that the member may transfer the “net present value of the member’s interest in the defined benefit plan”, while ACA 1x specifies the “net present value of the member’s interest”. Neither term is defined. While these terms could have multiple interpretations, it is possible that the transferred funds could include employer contributions from the DB plan.

The potential transfer of employer assets to a DC plan could provide a drain of employer assets not previously considered in the funding assumptions used by DB plans. The loss of employer assets reduces the funds available for investments, which will have an adverse impact on employer costs.

[6] A number of assumptions were used to derive this estimate. Following are the most significant:

- This estimate is a comparison between contributions to the CalPERS DB plan as an open system, compared to the combined contributions to a closed DB plan and a DC plan, as proposed under ACA 5 and ACA 1x.
- Assumed employer contribution rates include an additional 3% DC plan contribution for those employees excluded from Social Security. Assumed employer contribution rates are as follows: 6% for state miscellaneous, school, and state industrial; 7.5% for public miscellaneous (due to Social Security coverage, half assumed at 6% and half at 9%); 12% for safety (most excluded from Social Security).
- The cost savings do not include any costs associated with the provision of death and disability benefits; savings may be lost if employers sought to provide these benefits through other means.
- It is assumed that these bills would supercede the 2-year deferral period provided under the Alternative Retirement Program created in 2004.
- It is assumed that no existing members will elect to transfer the present value of benefits to a DC plan. Any such transfers will have an adverse impact on employer rates.

15. Impact on Members

Requiring future public employees to participate in a DC plan will have a fundamental impact on their financial security. Rather than having a guaranteed, lifetime retirement benefit as provided under the CalPERS DB plan, their retirement benefit will be based on the ability to manage personal retirement investments and the status of the financial markets at the time they retire. Upon retirement, future employees would also need to adjust their investment portfolio to a lower level of risk, earning even lower returns than available to CalPERS DB plan.

Mortality Risk
In a DC plan, a retiree may outlive his or her benefit. A DB plan, on the other hand, insures that a retiree will not outlive retirement benefits by providing a guaranteed, lifetime benefit. This risk is pooled among the participants of the DB plan with average mortality ages figured into the normal cost of the plan. This is a significant issue since a stable source of income is critical for the health and well-being of retirees.

Social Security
The many public employees not participating in Social Security would be significantly impacted by this legislation. Without access to Social Security benefits or to a lifetime, guaranteed benefit under the DB plan, these individuals will be left without a retirement safety net.

Applicability to New Employees
It is not clear whether ACA 5 and ACA 1x would apply to all new members or to all new employees—the difference being whether a newly hired employee that is already a member of CalPERS would have the ability to remain in CalPERS for future service, or whether an employee with reciprocity rights under another system would be considered a new employee under the system.

Safety Employees
The author has indicated that the maximum employer contribution for sworn police officers and firefighters would be higher than the contribution for other public employees. This definition is much narrower than the definition of a safety employee under CalPERS. Therefore, some safety positions would receive a more significant reduction in retirement compensation than others. Because many safety employees are excluded from Social Security, it is also possible that some existing safety classifications would receive less in retirement than miscellaneous employees, even taking into account a higher employer contribution to a safety employee's DC plan.

16. Impact on Employers

Under current law, local agency employers may bargain with employee representatives for the benefit formula, but the employer contribution rates are determined by CalPERS based on the annual valuation process. Under ACA 5 and ACA 1x, a local agency could bargain with employee representatives for the amount of the employer contribution rate to be contributed to the DC plan, subject to certain limitations.

Local agency employers also currently have discretion in choosing a retirement plan for their employees. For those that contract with CalPERS, CalPERS has a fiduciary duty for the administration of benefits and the investment of the fund. Under ACA 5 and ACA 1x, even if the employer elects to contract with a third party to provide plan administration, the employer will have the fiduciary duty to make a prudent selection of the plan administrator and the selection of investment options.

In addition, if any employees currently excluded from Social Security become subject to Social Security under the DC plan, then the employer and employee will each be required to contribute an additional 6.2% of payroll. Federal law requires that in order to be excluded from Social Security, an employer must provide a retirement system with contributions, whether member or employer, equaling 7.5% of payroll. Any individual with benefits falling below this amount must be enrolled in Social Security.

Finally, replacing the CalPERS DB plan with a DC plan is likely to impact recruitment and retention of public employees. Many public employees have a lower salary then their private sector counterparts, especially positions like doctors, nurses, engineers, and attorneys. Retirement benefits and retirement enhancements have often been offered in lieu of pay increases.

17. Many public employers would be required to maintain multiple retirement plans.

Because ACA 5 and ACA 1x only impacts employees hired on or after July 1, 2007, existing public employees would remain enrolled in their existing DB retirement plans. In the case of CalPERS contracting agencies, the agencies would remain in CalPERS for their existing employees, while also providing a DC retirement plan for new public employees. This is likely to increase administrative costs for the agency.

With respect to state employees, existing state employees would remain in CalPERS, and the state would also maintain a DC plan for all new state employees. The Alternative Retirement Program enacted during 2004 would also be administered by the Department of Personnel Administration through July 1, 2009. Presuming that the DC plan provided under ACA 5 and ACA 1x would supercede the Alternative Retirement Program, the Alternative

Retirement Program would apply to those employees hired before July 1, 2007, and must remain in effect through the first two years of employment. The state, therefore, would be maintaining three retirement programs.

18. <u>Concern regarding employer rate fluctuations can be addressed through other means.</u>

In California, when the economy is strong, tax revenues are high while employer pension costs decline as a result of strong investment returns. Conversely, when the economy is weak, tax revenues lag while employer pension costs increase as a result of weak investment returns.

This dynamic between DB plan returns and tax revenue is directly correlated and is cyclical. The state is currently experiencing the effects of increased employer contribution rates along with reduced income tax revenue. Rather than eliminating DB plans, there are alternative solutions to addressing this funding issue.

19. <u>Legislative Policy Standards</u>

The Board's Legislative Policy Standards suggest an oppose position on proposals which: (1) threaten the Trust; (2) create a benefit change for a subcategory within a member classification, unless the proposal promotes the concept of Board-approved pooling; or, (3) reduce or limit the Board's administrative authority. An oppose position would also be consistent with CalPERS' policy on AB 3252, the 1996 legislation allowing the transfer of CalPERS' DB plan members to a DC plan.

ACA 5 and ACA 1x would create a fundamental shift in the retirement security of future public employees, replacing the guaranteed, lifetime benefit provided under a DB plan with a fixed amount provided at retirement under a DC plan. The value of professionally managed investments, pooling of participant investment risk, inflation protection, and catastrophic death and disability benefits would be forfeited under a DC plan.

In addition, ACA 5 and ACA 1x would result in a consistently aging population in the DB plan, creating an adverse effect on the actuarial balance of the funds administered by CalPERS.

V. STRATEGIC PLAN:

This is not a specific product of the Annual or Strategic Plans, but is part of the regular and ongoing workload of the Office of Governmental Affairs.

VI. RESULTS/COSTS:

ACA 5 and ACA 1x would close the current CalPERS DB plan to any new enrollment, but would not eliminate the plan. Current DB plan members would be eligible to continue to participate in the CalPERS DB plan by accruing service credit and receiving retirement benefits. Contracting agencies and the state would be required to fund any liabilities accrued with respect to the remaining DB plan participants.

Program Costs

While there is a number ways that unfunded liability could be amortized, the amounts shown below are based upon the only interpretation available of CalPERS' current policy, namely that the amortization payments would have to start higher and decrease over time as the payroll of covered active employees declines. Further, the amounts shown below are based on no change in amortization period. Should either bill be enacted, the Board would have to determine whether the method and period used to produce the estimate below are appropriate. Please refer to Issue 13 above for a full discussion of this amortization issue and the assumptions used in this estimate.

Estimated Fiscal Impact of the Proposal (in $ billions)
Amortization Method: Level Percent of Declining Payroll
Amortization Period: Same as Current Policy

	First Year (2007-08)	Ten Years (2007-08 to 2016-17)	Twenty Years (2007-08 to 2026-27)	Thirty Years (2007-08 to 2036-37)
State	(0.42)	(1.52)	8.14	19.00
Schools	(0.14)	(0.18)	2.88	5.64
Public Agencies	(0.26)	0.67	4.89	11.20
Total	**(0.82)**	**(1.03)**	**15.91**	**35.84**

Negative amounts represent increased cost to employers and positive amounts represent decreased cost to employers.

Administrative Costs

The administrative costs for the CalPERS DB plan are not likely to change significantly in the short-term. ACA 5 and ACA 1x would, however, multiply the administrative costs of the state and local agencies by requiring public employers to maintain multiple retirement systems, as explained in Issue 17 above. The DC plan is also likely to have higher administrative costs per employee than the costs of CalPERS DB plan, as explained in Issue 6 above.

Karen Neuwald, Chief
Office of Governmental Affairs

Robert D. Walton
Assistant Executive Officer
Governmental & Administrative Services Branch